

**Performance Audit**  
**Managing the Risks of Increased Debt**

August 2005

**City Auditor's Office**  
**City of Kansas City, Missouri**

August 23, 2005

Honorable Mayor and Members of the City Council:

The city doubled its tax-supported debt in the last year. The city issued debt to pay for the downtown entertainment district, the arena, deferred capital improvements, several TIF projects, zoo expansion, the Liberty Memorial museum, and Bartle Hall expansion. The city owed just over \$1 billion in principal and interest on outstanding tax-supported debt at the end of fiscal year 2004. At the end of fiscal year 2005, projected principal and interest payments on outstanding tax-supported debt was about \$2.3 billion. We conducted this performance audit to assess whether the city has tools in place to monitor and manage the risks associated with increasing debt.

The primary risk of debt financing is that it reduces flexibility in future year budgets – debt service obligations can crowd out spending on other priorities such as public safety or infrastructure maintenance, force the city to raise taxes, or both. Because incurring debt has long-term consequences, the Government Finance Officer's Association (GFOA) and National Advisory Council on State and Local Budgeting (NACSLB) recommend governments adopt a formal debt policy that spells out conditions of issuance, limits on outstanding debt, use of different types of pledges and criteria for issuance, structural features that may be considered, selection of external financial professionals, refunding of debt, disclosure and compliance with other federal tax law provisions, and integration of capital planning with debt financing activities. The city does not have a formal debt policy, although we've recommended in the past that the city adopt financial policies – including debt policies. While the city's Finance Department has followed recommended practices when issuing approved debt, the lack of consistent policies to monitor debt capacity and weigh new debt exposes the city to risk. Finance staff takes steps within individual debt issues to protect the city's interests, but decisions about using and structuring debt should be part of a broad policy framework rather than driven by support for individual projects.

With the current debt level and tight budget, the city has little room for error. Bond rating agencies base their current stable outlook for the city on expected population and development growth and current favorable rating on management's willingness to restructure the organization and rebuild fund balance. The city could face a downgrade in rating even without an economic downturn if, for example, management runs into difficulty managing the reorganization, continues to release the Comprehensive Annual Financial Report much later than it should, or growth doesn't meet expectations.

We recommend the City Manager draft for Council consideration debt capacity and debt management policies that outline the purposes for which debt can be used, limitations, types of debt and criteria for issuance, structural features that may be considered, credit objectives, method of sale, refunding

provisions, and disclosure and compliance requirements. The debt policies should be integrated with the city's capital planning and annual budgeting processes, should provide for staff analysis of all debt issues prior to consideration and approval, and should provide mechanisms for on-going monitoring and reporting. Because debt has a direct impact on the city's budget, we recommend the Mayor re-establish oversight of the budget and finance functions within one standing committee.

We provided draft reports to the Mayor, City Manager, and Acting Finance Director for review and comment. The City Manager's response is appended. We appreciate the courtesy and cooperation of city staff and contract advisors during the audit. The team for this audit was Julia Talauliker, Vivien Zhi, and Amanda Noble.

Mark Funkhouser  
City Auditor

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# Managing the Risks of Increased Debt

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## Managing the Risks of Increased Debt

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## Introduction

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### Objectives

We conducted this performance audit on managing the risks of increased debt pursuant to Article II, Section 13 of the Charter of Kansas City, Missouri, which establishes the Office of the City Auditor and outlines the City Auditor's primary duties.

We decided to audit the city's practices for managing and monitoring tax-supported debt because the city has substantially increased its debt load in a short amount of time. The city doubled its tax-supported debt in the last year. While borrowing increases the city's ability to meet needs now, the increasing debt load could limit the city's flexibility in making budget decisions in the future. Because incurring debt has long-term consequences, the Government Finance Officer's Association (GFOA) and National Advisory Council on State and Local Budgeting (NACSLB) recommend governments adopt a formal debt policy. The city has not adopted a formal debt policy and since April 2002 has lacked a mechanism to measure and track debt capacity.

A performance audit is an objective, systematic examination of evidence to independently assess the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making.<sup>1</sup> We designed this audit to assess:

- Are tools in place to monitor and manage the risks associated with the city's increasing debt?

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### Scope and Methodology

We focused our audit on tax-supported debt issued through April 2005. Our analysis excludes revenue bonds, which the city issues for enterprises – aviation, water, and sewer – and repays from service fee revenues. We followed generally accepted government auditing standards in conducting our work, which included:

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<sup>1</sup> Comptroller General of the United States, *Government Auditing Standards* (Washington, DC: U.S. Government Printing Office, 2003).

- Reviewing professional literature and interviewing experts to identify internal and external risks associated with debt.
- Reviewing documents, procedures, and reports and interviewing staff to flowchart how the city monitors and manages debt.
- Reviewing eight debt issuance and continuing disclosure files to test whether staff followed procedures.
- Comparing city processes to recommended GFOA and NACSLB guidelines.
- Assessing how city processes work to mitigate risks.

We omitted no privileged or confidential information from this report.

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## **Background**

Debt financing is a tool local governments can use to meet major capital needs. Borrowing to finance long-term projects spreads payment across the life of the asset so people – now and in the future – who will benefit from using the asset pay for it. Prudent use of debt can help address immediate needs. Prudent use of debt can also save money compared to pay-as-you-go financing by avoiding construction delays. However, over reliance on debt can be costly as interest payments increase the total cost of a project.

Debt is characterized by the type of pledged security – what the issuer provides as guarantee of repayment. The strength of the guarantee affects the risk to the investor that the issuer will default on its debt and therefore the price (interest rate) the issuer needs to pay for financing. A local government issuing debt can pledge its power to levy taxes, specific revenues, or the property being financed to guarantee its promise to repay the debt with interest. General obligation bonds – also called full faith and credit bonds – secure debt with the government’s authority to tax and are the least risky for the investor and least expensive for the government to issue. Debt secured by property or a future revenue stream are riskier for the investor and therefore more expensive to issue. The issuer can reduce the risk to the investor by purchasing insurance or by agreeing to appropriate enough money annually to fulfill its obligations even if the anticipated revenue stream is less than expected.

The city enters into several types of tax-supported debt:

- **General Obligation Bonds** – The city is authorized to issue general obligation bonds payable from ad valorem taxes to pay for improvements, property, or other municipal purposes excluding current expenses in the year of issue. Voter approval is required to issue general obligation bonds. Bonds must be issued within 12 years after voter approval and must be used for their designated purpose. The Missouri Constitution caps the amount of general obligation debt that the city can carry at 20 percent of the value of taxable tangible property. The city has used or is using general obligation bonds for projects such as streetlight improvements, the zoo, Liberty Memorial expansion, and Chouteau bridge replacement.
- **Sewer Special Assessment** – The city issued a series of bonds for sanitary sewer improvements payable from special assessments and ad valorem taxes. These bonds also fall under the state general obligation cap.
- **Neighborhood Improvement District** – The city is authorized to issue bonds for certain neighborhood improvement districts without a vote. The bonds are payable from special assessments, but if not so paid are payable from current income and revenues and surplus funds. Neighborhood improvement district bonds are treated as general obligation debt under state law, except the city is not authorized to impose any new or increased ad valorem property tax to pay principal and interest on these bonds without voter approval.
- **Leasehold Revenue Bonds (KCMAC)** – The city may finance equipment purchases, capital improvements, or facility expansions through a series of lease arrangements with the Kansas City Municipal Assistance Corporation (KCMAC), a nonprofit corporation. This method of debt financing does not require voter approval and does not count under the state general obligation cap as long as the lease is terminable and does not obligate the city to raise taxes to satisfy the indebtedness. The city leases the equipment, improvements, and facilities from KCMAC for payments equal to the debt service requirements of the bond issues. The leases are renewable annually with payment subject to annual appropriation of funds. The city has used KCMAC bonds for projects such as Bartle Hall improvements, the 11<sup>th</sup> and Oak parking garage, Hodge Park golf course, and ERP software and implementation.



- **Lease Purchase Agreements** – The city can also enter into lease purchase agreements for capital equipment or projects payable from existing non-general fund revenues; earmarked revenues approved by the voters; or incremental existing general fund revenues. The city has used lease purchase agreements to pay for fire trucks, crime lab equipment, computer software leases, and video displays for Municipal Auditorium and Kemper Arena. Lease purchase agreements do not require voter approval and do not fall under the state general obligation cap as long as the lease is terminable and does not obligate the city to raise taxes to satisfy the indebtedness.
- **Limited Obligation Notes and Bonds** – The city has agreed, subject to annual appropriation to pay any debt service not covered by operating revenues for the project for which the bonds are issued. Most limited obligation bonds backed by the city’s annual appropriation pledge are for TIF or other economic development projects such as the Hotel President redevelopment, Blue Parkway Town Center Retail project, 909 Walnut Garage, the downtown entertainment district, and the arena. Limited obligation notes and bonds do not require voter approval and do not fall under the state general obligation cap.

Limited Obligation bonds are currently the largest portion of tax-supported debt with \$1.06 billion due over the next 35 years. KCMAC is the next largest portion of tax-supported debt with \$865 million due. (See Exhibit 1.)

Exhibit 1. Principal and Interest Payable through 2040 on Debt Outstanding as of 4/30/05

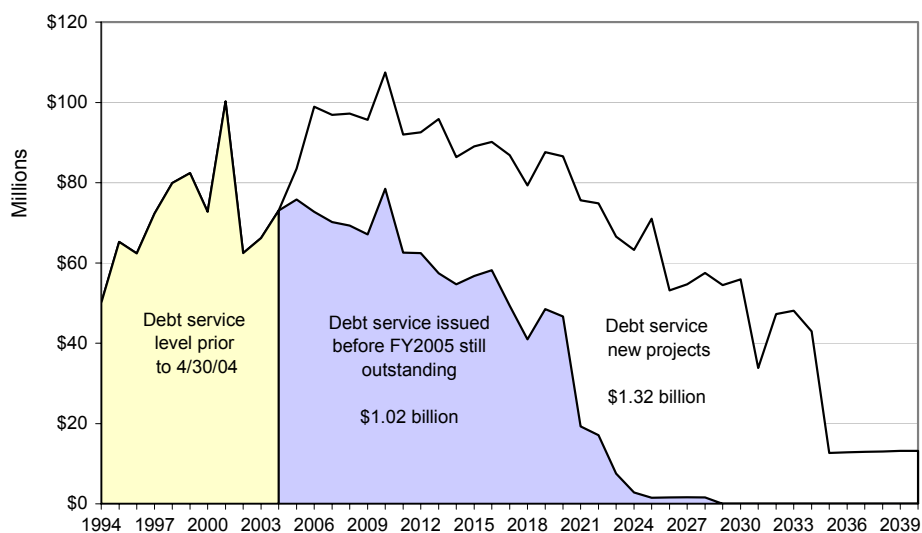
Limited Obligation Bonds	\$1,061,219,018
Leasehold Revenue Bonds – KCMAC	\$864,730,949
General Obligation Bonds	\$371,432,640
Lease Purchase Agreements	\$36,566,257
Sanitary Sewer Improvements	\$8,084,251
Neighborhood Improvement District	\$948,348
<b>Total</b>	<b>\$2,342,981,463</b>

Source: Debt Manual payment schedules.

The total principal and interest due on the city’s current tax supported debt is about \$2.3 billion through 2040, not counting debt that has been authorized but not yet issued. Debt service (principal and interest) for fiscal year 2005 was \$83.3 million. The spike in 2001 was due to refunding Public Safety and Zoo Improvement Bonds and retiring Special Obligation Bonds worth \$49.3 million. The city’s debt service

obligation on current outstanding debt will increase to \$107.5 million in 2010, excluding additional bonds that might be issued between 2006 and 2010. The city's debt service obligation is reduced after 2010 as bonds are retired. The last payments are due in fiscal year 2040. (See Exhibit 2.)

Exhibit 2. Scheduled Debt Service Payments on Tax-Supported Debt<sup>2</sup>



Source: Debt Manual payment schedules.

<sup>2</sup> These figures do not include \$220 million that the city is still authorized to issue for deferred maintenance, the Zoo and Liberty Memorial projects or \$256 million in additional debt the city plans to issue in fiscal year 2006.



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## Findings and Recommendations

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### Summary

The primary risk of debt financing is that it reduces flexibility in future year budgets and can crowd out spending on other priorities, force the city to raise taxes, or both. Because incurring debt has long-term consequences, the Government Finance Officer's Association (GFOA) and National Advisory Council on State and Local Budgeting (NACSLB) recommend governments adopt a formal debt policy. The city does not have a formal debt policy. While the city's Finance Department has generally followed recommended practices in issuing debt, the lack of consistent policies to monitor debt capacity exposes the city to risk. Finance staff takes steps within individual debt issues to protect the city's interests to the extent possible, but decisions about using and structuring debt should be part of a broad policy framework rather than driven by support for individual projects, however worthy.

The city's relatively high level of tax-supported debt and tight budget make it particularly vulnerable to adverse economic trends. However, the city's financial position could be hurt even without an economic downturn. Bond rating agencies have continued to rate the city's bond issues favorably, primarily due to expected population growth, development potential, strength of financial management, and management's commitment to restructuring the organization and rebuilding fund balance. Lower than expected growth, difficulty in managing the reorganization or continued late release of the city's Comprehensive Annual Financial Reports could hurt the city's credibility with bond rating agencies. The city has little room for error. Adopting debt capacity and debt management policies would strengthen monitoring and oversight of tax supported debt and bolster the city's long-term financial position.

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### Debt Issuance Practices Generally Sound, but Absence of Policies Weakens Decision-Making and Oversight

Government borrowing obligates future revenue and therefore carries risk. GFOA and NACSLB recommend governments adopt debt capacity and debt management policies. The city has not enacted formal policies and no longer benchmarks debt capacity as part of the monthly financial

report. While the Finance Department generally follows recommended practices when issuing debt, economic development debt isn't subject to the same type of analysis as other types of debt before it is presented to the City Council. Limited obligation debt for economic development projects amounts to about 45 percent of the city's outstanding principal and interest payments – over \$1 billion. The City Council relies on pro forma analysis from the developers when making decisions about these projects. Lack of independent analysis by city staff prior to considering the projects exposes the city to risk.<sup>3</sup>

We recommend the City Manager draft debt capacity and management policies for City Council consideration. The policies should be integrated with the city's capital planning and budgeting processes, provide for staff analysis of all debt issues prior to consideration and approval, and provide a mechanism for ongoing benchmarking and monitoring. We also recommend the Mayor re-establish oversight of the budget and finance functions within one standing committee of the City Council.

### **Policies Reduce Risks of Government Borrowing**

Borrowing obligates future revenue and therefore carries risk. Borrowing is a reasonable method for a government to meet major capital needs while providing for inter-generational equity because payments are spread across the life of the asset. However, borrowing also increases the cost of a project, can hide a project's true cost, and pushes costs into the future. Use of debt can allow a government to defer difficult spending decisions.

**Borrowing can limit future flexibility.** A government that relies too much on debt financing reduces its ability to pay for other priorities in the future as debt service obligations crowd out spending for other priorities such as public safety or street maintenance. Unanticipated changes in revenues or expenditures could also hurt a government's ability to repay debt. Debt service obligations could force a financially strapped government to cut services or raise taxes beyond a level acceptable to its residents. In rare cases, governments have defaulted on debts, greatly reducing their ability to provide public services.

Because debt can be misused, state governments require voter approval of debt and impose limits on the amount of debt local governments can issue. The federal government restricts uses of tax-exempt debt and

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<sup>3</sup> In our 1998 audit of Tax Increment Financing we concluded that developers' revenue projections systematically overstated revenue and that there was a clear tendency to overstate the projections. Projections are part of the proposals made by developers who have interest in securing public incentives.

requires disclosure on debt issues. The federal Securities and Exchange Commission (SEC) regulations broadly exempt municipal securities except for antifraud provisions – primarily disclosure rules. SEC regulations cite Government Finance Officers Association (GFOA) disclosure guidelines for state and local government securities.

**Debt management policies strengthen decision-making, oversight, and accountability.** The GFOA recommends cities establish financial policies to promote stability and continuity, standardize response to situations, educate decision makers without background in government financial management, and promote long-term thinking. A city's debt policies should cover the conditions or purpose for which debt can be issued, restrictions on debt issuance, debt service limitations, and limits on outstanding debt. According to GFOA, comprehensive and routine analysis of debt capacity prior to issuing bonds provides assurance that the amount of debt a government issues is affordable and cost effective.

#### Debt Policy

Debt policies are written guidelines and restrictions affecting the amount, issuance, process, and type of debt issued by the governmental entity. A formal debt policy is a recommended practice that should be followed by all jurisdictions issuing debt. A debt policy improves the quality of decisions, provides justification for the structure of debt issuance, identifies policy goals, and demonstrates a commitment to long-term financial planning.

##### Elements of a Debt Policy:

- Purposes for which debt can be issued
- Legal debt limitations, or limitations established by policy
- Use of moral obligation pledges
- Types of debt permitted to be issued and criteria for issuance
- Structural features that may be considered
- Credit objectives
- Method of sale
- Selection of external financial professionals
- Refunding of debt
- Disclosure
- Compliance with federal tax law provisions, including arbitrage requirements
- Integration of capital planning and debt financing activities
- Investment of bond proceeds where otherwise not covered by explicit written law

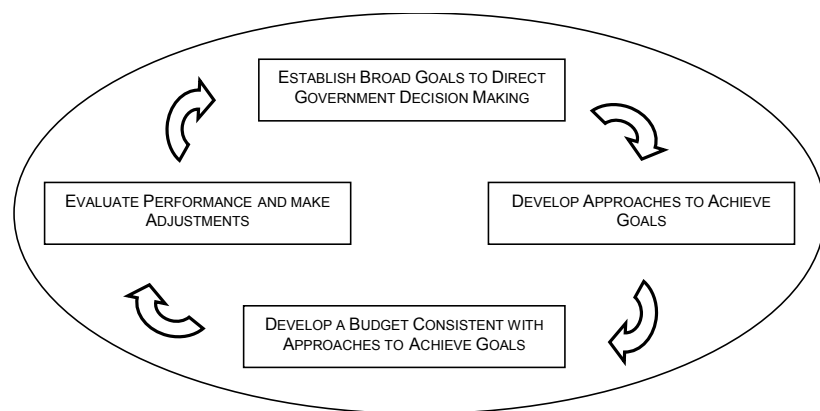
Source: Rowan Miranda and Ronald Picur, *Benchmarking and Measuring Debt Capacity*, GFOA, 2000.

Policies should also cover debt-structuring, issuance, and management practices including maximum term, average maturity, debt service pattern, use of optional redemption features, use of variable or fixed-rate debt, credit enhancements, short-term debt, capitalized interest, deferral of principal, and other internal credit support. According to GFOA, such policies improve long-term decisions. Debt management policies also help ensure compliance with regulations.

GFOA recommends that the legislative body formally adopt a debt policy and continuously monitor the program to ensure compliance. The policies should guide the Council and staff in making decisions. Without policies, the Council and staff are making financing decisions on a case-by-case basis and are reacting to situations rather than planning strategically. Because entering into long-term debt limits future flexibility, decisions should be made in the context of a policy framework that considers capacity now and in the future, limits, and priorities.

**Debt policies should be a part of budget framework.** The National Advisory Council on State and Local Budgeting (NACSLB) grouped recommended practices into an overall framework for improved government budgeting. According to the NACSLB, debt issuance and management policies should be integrated with other financial policies, particularly operating and capital budget policies. Adhering to a debt policy helps ensure that the government issues and manages debt prudently to maintain a sound fiscal position. (See Exhibit 3.)

Exhibit 3. NACSLB Overall Budget Framework



Source: *Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting*.

**Informal policies have shortcomings as a means of guiding staff.**

Informal policies lack the explicit support of the governing body. They

tend to be applied inconsistently, and may not stand the test of time as usefulness diminishes with staff turnover.<sup>4</sup> Informal practices are also less transparent to participants and other stakeholders than formal, adopted policies.

**Different standing committees to oversee budget and finance weakens oversight and reinforces project-by-project approach.** The Mayor divided the City Council's Finance and Audit Committee into two committees in 2003 – the Finance Committee and the Budget and Audit Committee. Prior to 2003, matters related to issuing debt went through the Finance and Audit Committee, which also dealt with the city budget. We are now concerned that separating oversight of budget and finance limits the context in which the Council makes financial decisions and reinforces a project-by-project approach.

Issuing debt has a long-term affect on the city budget because debt obligates city revenue to pay for debt principal and interest for many years. For example, the city's principal and interest on tax supported debt was \$73.1 million in fiscal year 2004 and is projected to be \$98.9 million in fiscal year 2006 and \$107.5 million in fiscal year 2010 even if no new debt is issued. Payments on current debt extend to fiscal year 2040. Such payments are fixed and take priority over other city expenditures. Making decisions about a particular project that involves debt financing should involve discussion about its affect on aggregate debt capacity, the city's budget, and other priorities. Capital projects should not be considered as independent projects, but should be viewed as one among alternatives that compete for limited resources. As more projects with debt financing are approved, fewer resources are available to spend on other priorities.

As debt financing becomes more sophisticated, it is important that decisions made by the Council are thought through and are based on meaningful discussions. Asking questions is part of the process. We encourage Council members to ask questions that enhance their understanding of the revenue sources available to the project, what alternative uses exist for those revenues, how sensitive the project is to changes in economic conditions, and what is the effect the project could have on the city's fiscal health in the long term. We recommend that the Mayor reestablish oversight of the budget and finance functions within one standing committee.

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<sup>4</sup> Kavanagh and Williams, *Financial Policies: Design and Implementation*, Government Finance Officers Association, (Chicago, IL: 2004), p. 4.



### **The City Council Has Been Reluctant to Enact a Debt Policy**

The City Council has been reluctant to enact a debt policy in the past because Council members did not want to limit their options to finance priority projects and because the city's bond rating has remained high. Management has been reluctant to present a set of policies to Council for adoption because Council discussions focused on issuing new debt.

**Council members want flexibility now.** Several Council members said that they're concerned that a debt policy would constrain their ability to make good decisions. They are concerned that a policy would limit flexibility to finance projects of interest and do not see the need for a policy because the city's bond ratings have remained high. In the absence of debt and other financial policies, term limits for Council members discourage long-term thinking.

**Management has not been advocating a policy.** City staff told us that they haven't presented financial policy initiatives to the City Council for consideration. Staff said that former finance directors were reluctant or politically unprepared to recommend policy without strong support from the City Manager.

**The city no longer benchmarks debt capacity.** The Finance Department used to calculate and report a debt capacity score each month using a method and comparing to a benchmark that the Community Infrastructure Committee recommended in 1997. However, in 2002, Moody's stopped publishing the comparative ratios that staff used to calculate the debt score. Staff presented an alternative way to benchmark debt capacity in an October 2002 business session, but the City Council took no action on the recommendation. While Finance lists amounts of outstanding debt for different projects in its monthly report, the city currently does not measure its debt capacity. The city's annual Comprehensive Annual Financial Reports (CAFR) reports a debt burden measure, but only includes general obligation debt, which is about 16 percent of the city's outstanding principal and interest payments.

### **Reliance on Bond Rating Agencies As a De Facto Debt Capacity Policy Is Risky**

A bond rating is a current opinion on the creditworthiness of an issuer with regard to particular debt issue. The rating signals to prospective buyers the willingness and ability of the issuer to make timely payments of amounts due over the term of the debt. While bond ratings serve an important function for the issuer by broadening the market for municipal

debt and providing incentive for officials to follow good planning and financial management practices, the rating is primarily a tool to protect investors. The ratings do not substitute for policy because they do not consider city priorities and strategic direction, do not guarantee sound financial practices, and rely on historical data. Downgrades in credit rating are likely to occur after the financial damage is already done. A downgrade from one A-level to the next would cost the city an additional 10 basis points – or 1/10<sup>th</sup> of a percent added to the interest rate. For example, on a \$350 million bond with an interest rate of 4.14 percent, an additional 10 basis points would cost \$4.5 million over 20 years.

**Ratings agencies rely on the city's information.** Analysts base their bond ratings on information from the issuer. Ratings services rely on the issuer, its accountants, counsel, advisors, and other experts to provide accurate, complete, and timely information. The ratings services are not obligated to verify the information submitted to them. The assignment of a rating to a security by ratings services should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information in connection with the rating or the results obtained from the use of such information.<sup>5</sup>

**Late financial reporting could hurt credit ratings.** Rating agency analysts review audited financial statements to develop bond ratings. Delays in issuing audited financial statements could adversely affect the city's relationship with the credit rating agencies. The city hasn't released its CAFR in a timely manner in recent years. The city used to release the CAFR about 6-months after the end of the fiscal year, but the time to complete it has been increasing. The last two CAFRs, for the fiscal years ending April 30, 2003, and April 30, 2004, were issued about 12 months after year-end.

Exhibit 4. Days between End of Fiscal Year and Release of Annual Report

Fiscal Years	Average Days from Fiscal Year end to CAFR Release
1980-1989	131
1990-1999	175
2000-2004	274

### **The City Council Should Establish Financial Policies**

We previously recommended the city adopt formal financial policies. We recommended in our 2001 analysis of the city's budget process that the City Manager prepare a resolution for City Council consideration proposing the adoption of written financial policies. We reported that

<sup>5</sup> Standard & Poor's Ratings Services – Code of Practices and Procedures, September 2004.

participants at our 2002 financial condition forum said the city needed a financial vision – where the city wants to be in 10 years – with a set of core financial policies, and recommended the city set policies and stick to them.

In our review of the submitted budget for fiscal year 2006, we again pointed out that the city lacks adequate financial policies. We recommended that the City Manager direct staff to conduct policy research and submit draft financial policies for City Council consideration. The City Manager should also direct staff to incorporate the city's financial policies into financial documents and to establish a review process to ensure that policies remain relevant.

The Charter Review Commission in its recommendation of July 11, 2005, proposed including language that the Council shall enact by ordinance a policy that reflects best practices for the prudent issuance, management, and use of debt, including bonds, and the use of economic incentives.

**Do Financial Policies Limit Flexibility?**

There is a choice between flexibility and accountability when designing financial policies. Nonetheless, a government should be able to create a financial policy that provides useful guidance without being overly restrictive. In any event, since financial policies should be subject to annual review, any policy that has proved to be excessively restrictive can be revised at that time.

Source: *Financial Policies: Design & Implementation*, GFOA, 2004.

**Finance Generally Follows Recommended Practices in Issuing Debt**

Finance Department staff generally follows recommended practices when issuing debt, but economic development debt and some special projects are not subject to the analytic controls of other types of debt. Decisions about using and structuring debt should be part of a broad policy framework rather than driven by individual projects.

**Debt issuance procedures generally follow recommended practices.**

Finance Department procedures describe the types of analysis staff should perform before recommending debt financing to the City Council. These include feasibility studies, internal cash flow analysis, and developing a long-term financing plan. The procedures state the responsibilities of the different parties involved in issuing debt – staff from the Treasury Division, Office of Management and Budget, Law

Department, financial advisor, bond counsel, bond issuing department and the City Council. The procedures also describe the major steps and timetable for issuing bonds. The procedures and checklist for bond issuance outline types of legislation required for the bond issuance and detailed activities involved in issuing bonds. Exhibit 5 compares current city practices in issuing debt to GFOA recommended practices. We illustrate the general process for issuing GO bonds in appendix A.

**Exhibit 5. Comparing City Debt Management Practices to Recommended Practices**

GFOA Recommended Practices	City Practices
Policy to determine the method by which bonds will be sold, either competitively or on a negotiated basis.	Competitive sale is required for all GO and revenue bonds.  KCMAC, Lease Purchase, and economic development debt could use negotiated sale.
Policy on use of professional services, such as financial advisor, bond counsel, underwriter, and paying agent/registrar to help authorize, structure, market, and administer debt obligations.	Finance follows an RFP process to hire a financial advisor.  Law hires a bond counsel for each project.
Policy regarding public disclosure.	Municipal debt information is included in the adopted budget and CAFR.  City contracts with independent financial advisor and bond counsel to prepare documents.
Repayment provisions are guidelines for the repayment of interest and principal for bonds issued.	Financial Advisor analyzes internal cash flow and long term financing plan and Budget reviews the analyses before presenting proposal to Council.
Ideal practice dictates that bond maturities not exceed the useful life of assets purchased with the proceeds.	The Bond Counsel has to sign off on the useful life.  Finance sends out a questionnaire to the bond issuing departments asking them about the useful life.
Policy on debt service fund.	Definition of the debt service funds and types of debt service funds are described in CAFR.

The city's controls include analysis, staff expertise, oversight, bond ratings, and competitive sales. However, without a policy framework, some types of debt aren't subject to analytic controls. The city also lacks aggregate reporting and benchmarks. Finance monitors continuing disclosure requirements and oversees the investment of bond proceeds to ensure that investment earnings are not higher than the arbitrage rate. Budget tracks spending of bond proceeds by project to ensure that proceeds are spent as intended.

**Economic development debt isn't subject to analytic controls before the city decides to go ahead with the project.** The city's process for issuing general obligation debt calls for the Office of Management and Budget to analyze cost-benefit and cash flow before recommending a debt issuance to the City Council. (See Appendix A). However, OMB does not perform this analysis for debt related to economic development or other projects not initiated by city departments. None of the files we reviewed included such analysis. The budget officer said the city makes decisions about these forms of debt based on projections made by the developer, which aren't reviewed by OMB staff before the City Council approves the projects.

Comprehensive and routine analysis of debt capacity prior to the decision to issue bonds provides assurance that the amount of debt issued by a government is affordable and cost effective.<sup>6</sup> Lack of analysis increases the risk that the city will overextend its capacity to pay for debt and reduce its ability to pay for other priorities.

To the extent possible, Finance staff takes steps to protect the city's interest when structuring debt for individual projects. Finance staff includes safeguards in some projects to protect against poor performance. For example, Hotel President has a guarantee agreement and 909 Walnut has a special assessment tax lien exclusive of the residential towers.

The city also issues variable interest rate bonds for limited obligation debt when finance staff is concerned that the project might not perform well. If the private partner doesn't fulfill its obligations, the city can abandon the project and pay off the bonds early without penalty. While variable rate bonds offer flexibility, such bonds also add fees and some uncertainty to the financing costs.

Variable rate bonds are more uncertain than fixed rate bonds because predicting future debt service cost is difficult. Short-term variable rate bonds currently offer a lower interest rate than long-term fixed rate

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<sup>6</sup> Rowan A. Miranda and Ronald D. Picur, *Benchmarking and Measuring Debt Capacity* (Chicago: Government Finance Officers Association, 2000), p. 5.

bonds, but additional fees associated with short-term variable rate bonds offset some of the savings and the interest rate may go up or down relative to the long-term interest rate.

The city issued five variable rate bonds in fiscal year 2005, all for limited obligation debt related to economic development projects. The Finance Department has asked the city's financial advisor to identify the appropriate amount of variable rate debt.

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## The City Has Little Room for Error

The city's growing levels of tax-supported debt and tight budget make it particularly vulnerable to adverse economic trends. Increase in debt service requirements over the next few years exceeds expected revenue growth while the general fund balance is at its lowest point in years. Unanticipated changes in revenue or expenditures due to population loss, reduced commercial activity, or loss of property value would limit the city's ability to fund other priorities, as revenues would be redirected to cover debt service. The city has little room for error.

**The city's debt service was comparable to other jurisdictions, before increase.** We compared the city's debt level with six other cities in the metropolitan area and region.<sup>7</sup> Between fiscal years 2000 and 2004, the most recent year for which data are available, the city's debt service as a percentage of revenues was comparable to the other cities. However, the city increased its debt service by about 35.4 percent over the last two years. The city plans to issue an additional \$256 million in debt for various projects in 2006.<sup>8</sup> In addition, the city is still authorized to issue \$220 million for deferred maintenance, the zoo, and Liberty Memorial projects. (See Exhibit 6, next page.)

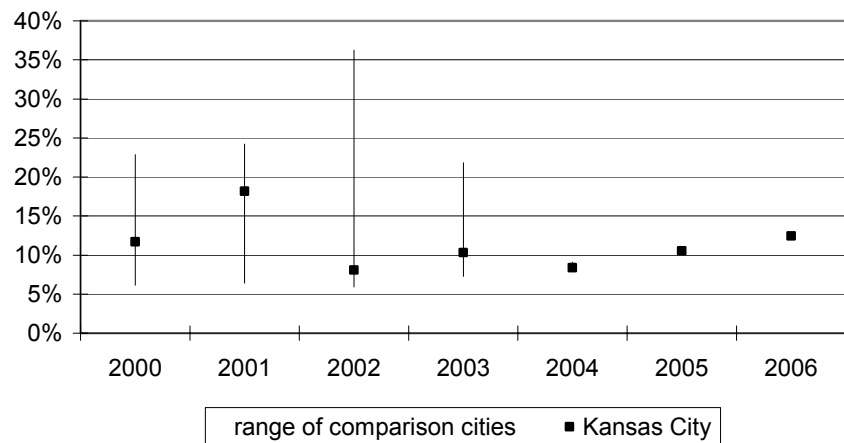
The city's tax-supported debt per capita, however, is higher than other cities in the area. The per capita debt service is also expected to grow from \$142 in 2004 to \$215 in 2006, an increase of 51 percent. The amount does not include additional debt to be issued in 2006. (See Exhibit 7, next page.)

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<sup>7</sup> The comparison cities are Independence and St. Louis, MO; Overland Park, Wichita, and Kansas City, KS; and Oklahoma City, OK.

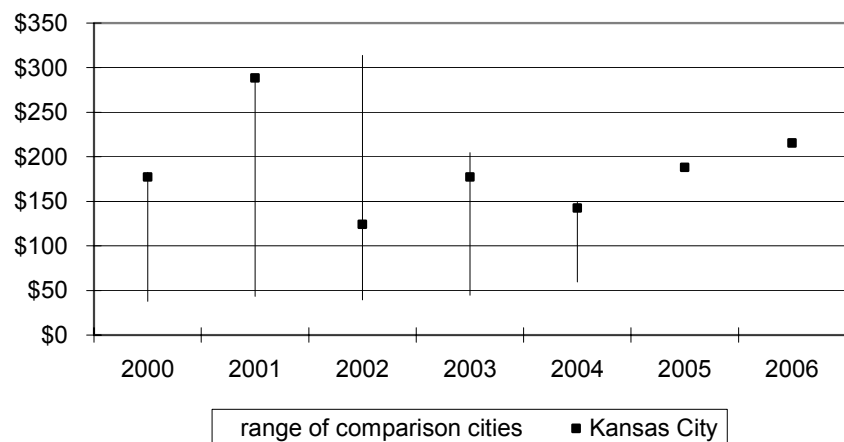
<sup>8</sup> These include phase two of the Entertainment District, American Airlines, HOK, H&R Block, Cerner, and Gailoyd TIF.

Exhibit 6. Debt Service as Percentage of Governmental Revenue



Sources: CAFR and Adopted Budget 2006.

Exhibit 7. Debt Service Per Capita



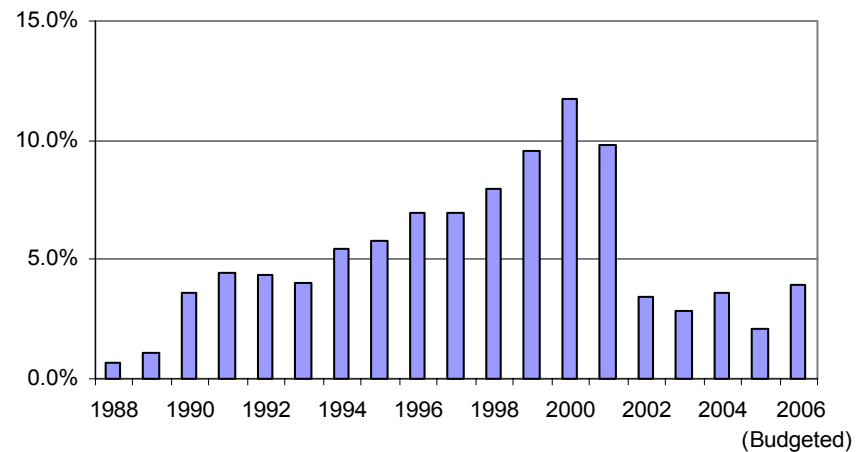
Sources: CAFR and Adopted Budget 2006.

**Increase in debt service requirements over next few years exceeds expected revenue growth.** The Office of Management and Budget's five year financial forecast projects average annual revenue growth of about 2.1 percent through 2010. Average annual growth in debt service will be about 5.5 percent. The forecast projects budget imbalances through fiscal year 2008 and relies on limited growth in salaries and benefits to balance revenues and expenditures in fiscal years 2009 and 2010. The forecast anticipates that 40 percent of general fund revenues – including sources such as utility, motor fuel, sales, and use taxes – will grow at a rate less than or equal to inflation. The forecast assumes no new expenditure commitments.

Limited obligation debt is now the largest category of city tax-supported debt with \$1.06 billion in principal and interest due over the next 35 years. The city is relying on specific revenue streams or commercial activity in specific geographic areas to meet debt service requirements on limited obligation debt. These types of revenue are more volatile than overall city revenues.

**The general fund balance is at its lowest point in years.** The city's unreserved general fund balance declined to 2.1 percent of expenditures in 2005, its lowest level in years. The City Manager acknowledged the depletion of the fund reserves and expressed his intent to rebuild the fund balance over the next several years. The 2006 adopted budget ends the year with a general fund balance of about 4 percent of expenditures, well below the target of 8 percent.<sup>9</sup> (See Exhibit 8.)

Exhibit 8. General Fund Balance as Percentage of Expenditures



Source: Adopted Budgets, 1989-2006.

Bond rating agencies base their current stable outlook for the city on expected population and development growth and current favorable rating on management's willingness to restructure the organization and rebuild fund balance. Unanticipated changes in revenue or expenditures due to population loss, job loss, reduced commercial activity, or loss of property value would affect the city's ability to repay. Difficulty in managing the reorganization, difficulty in reestablishing fund balance, or continued late release of the city's Comprehensive Annual Financial Reports could also hurt the city's credibility with bond rating agencies. The city has little room for error.

<sup>9</sup> Resolution 980506.



## **Recommendations**

1. The City Manager should draft debt capacity and management policies for City Council consideration. The policies should be integrated with the city's capital planning and budgeting processes, provide for staff analysis of all debt issues prior to consideration and approval, and provide a mechanism for ongoing benchmarking and monitoring.
2. The Mayor should re-establish oversight of the budget and finance functions within one standing committee of the City Council.

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## **Appendix A**

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### **Flowchart of General Obligation Bond Issuance**



(Flowchart is a separate item.)



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## **Appendix B**

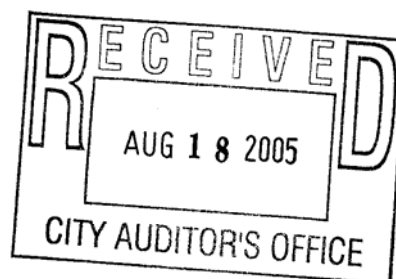
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### **City Manager's Response**





## Office of the City Manager



**DATE:** August 18, 2005

**TO:** Mark Funkhouser, City Auditor

**FROM:** Wayne A. Cauthen, City Manager *W.A.C.*

**SUBJECT:** Response to the Draft Audit Report on Managing the Risks of Increased Debt

Thank you for the opportunity to respond to recommendation 1 included in your draft audit report on Managing Risks of Increased Debt. Below you will find my response.

### **Recommendation:**

*The City Manager should draft debt capacity and management policies for City Council consideration. The policies should be integrated with the city's capital planning and budgeting processes, provide for staff analysis of all debt issues prior to consideration, and provide a mechanism for ongoing benchmarking and monitoring.*

### **Agree**

The development of debt capacity and management policies for City Council consideration should be undertaken. This provides the opportunity to codify some of the city's existing practices, which include, but are not limited to, the best practices as recommended by the Government Finance Officer's Association for debt issuance and management of the city's debt portfolio. Any debt capacity and management policy has to take the capital planning and budgeting processes into consideration.

With that said, the policies that the city adopts should be flexible enough not to impede Development but provide parameters necessary to assess the future growth and development of the city.